COMMENTS

BY
ADRIENNE WARREN, *Scotia Bank*

Our research at Scotiabank has been geared mainly toward statistical analysis, though as we've discussed today, even that is not always clear-cut. We established the NAFTA Quarterly, or Bulletin ALENA, publication a couple of years ago with the goal of raising knowledge of and encouraging discussion in a public forum of some of the key trends and changes that have occurred in North America under the FTA and NAFTA. Too often, decisions appear to be made behind closed doors and the potential macroeconomic impacts misunderstood in the midst of all the rhetoric. We also wanted to look at the possible economic implications of furthering trade liberalization, either through an FTAA or more broadly within the WTO.

I thought I'd take this opportunity to highlight just a few of our findings and what they might imply for future negotiations.

Goods trade

It is little disputed that NAFTA has had a large impact on North American goods trade. Growth in NAFTA goods exports in the 1990s matched the rise in Asia and was almost double that in Europe and Latin America. Our share of global exports has risen 3 percentage points to 20%. We've seen a bit of a reversal of this trend over the past two years, with North America (along with Asia) being hardest hit by the global slowdown due to its leading position in the high-tech sector.

As in other parts of the world, we're seeing a clear trend toward the formation of a regional trading bloc. *Intra*-regional exports have been growing about twice as fast as *extra*-regional exports. As a result, *intra*-regional exports now account for about 46% of NAFTA trade, up from under 40% in 1990. This in turn appears to be driven by two-way trade in similar products, particularly in the areas of office & telecommunications equipment and automotive products.

In terms of market share, Mexico has witnessed the fastest rise in export volumes, capitalizing on its low cost position. Mexico's share of the U.S. import market has roughly doubled to 11% under NAFTA, while Canada's has held steady at around 19%. Canada and Mexico compete in similar products – mainly transportation equipment, electronics and machinery – and Canada has outpaced Mexico in only 6 of 24 major industry groups, interestingly almost all of them resource-based. On the other hand, Canada has managed to maintain its U.S. market share while others, most notably Japan, have lost considerable ground.

Based on these trends, expanding NAFTA to an FTAA in the area of goods should be relatively easy to attain because we're already part way there through NAFTA and other existing bilateral and regional agreements such as the Canada-Chile and Canada-Costa Rica trade pacts. I would expect further large gains in export volumes and that the Americas share of global trade would continue to rise. A further concentration of trade within the region is likely, possibly until we reach something similar to the EU experience of about 60-65%, where intra-regional trade then seems to stabilize. I would also expect further market share shifts in favour of the newer emerging market partners. Canada will have difficulty hanging on to its 20% share of the U.S. goods import market but should fare better than the developed economies outside of the agreement, and Mexico will likely experience much more modest market share growth. Expect to see the expansion or formation of various industrial clusters to exploit economies of scale and vertical specialization.

Services Trade

Services trade is perhaps more interesting because it has received less attention. Many service areas are still protected or not well suited for foreign competition, but are now being more aggressively incorporated into FTAA and WTO discussions.

Services trade has grown substantially under NAFTA, but it has lagged the rise in goods trade. The agreement expanded coverage of investment and services, but there are still many barriers, including telecommunications, legal and medical services. Globally, however, services trade is expanding at about the same pace as goods, so the region is falling behind in this important area.

There is a lot more geographical diversity in North American services trade, with about 60% of Canada's service exports geared to the U.S. market versus close to 90% for goods. Unlike goods, we've actually seen a decline in intra-regional services trade within NAFTA, to about 20% today from 25% in 1990. The structure of services trade is also quite different within each nation. Services accounts for about 25% of U.S. export receipts, but only 12% in Canada and 7% in Mexico. Globally, both Canada and Mexico rank low in service intensity.

Looking at the composition of exports, commercial services – including financial, architectural, engineering, audio/visual, research & development -- are easily the fastest growing, and now largest, services area in Canada and the U.S. The situation is different in Mexico where tourism receipts continue to dominate.

Here, I think we obviously have further to go, in part because we have not come as far. Most existing agreements (NAFTA and bilateral) are limited in terms of services coverage. Even a goods-focussed FTAA should lead to a solid expansion of services trade, but unless incorporated more aggressively, the region risks falling further behind.

In terms of market share, the U.S. would retain its dominance under an FTAA, but there is a lot of room for Mexico and Canada to grow. Canada has a competitive advantage over many other nations in the Americas because of its skilled workforce, well developed commercial services sector, and language and cultural similarities with the U.S. This advantage will become increasingly important as competition in the goods sector intensifies.

Direct Investment

Quickly, I would like to make a couple of points on direct investment. Trade and investment are generally complementary, and we've likewise seen a big increase in the volume of FDI within North America under NAFTA, mainly through merger & acquisition activity. As with services, however, *extra*-NAFTA FDI has outpaced *intra*-NAFTA FDI. It appears that by lowering trade barriers, NAFTA has reduced FDI incentives by decreasing the need for a physical presence to gain market access.

An FTAA would likely substantially boost the volume of FDI within the region, though not necessarily the concentration. The biggest winners, at least in terms of inward FDI, would be Latin America, which is already one of the fastest growing destinations.

Regional Trends

Finally, looking at a sub-national level there are also some interesting developments. All provinces of Canada have seen a sizeable rise in exports under NAFTA, but the most dramatic increase has been in the Prairies, led by Alberta. In fact, this is the only region to garner a larger piece of Canada's export market. The region has made big gains in the U.S. market, with energy playing a key role. But it also made big strides into the Mexican market, especially in the agri-food industry, to the point that the Prairies account for almost 40% of Canada's exports to Mexico. It appears that the driver was mainly cooperative agreements in the private sector and between regional governments.

In the U.S., the Southern and Western states have been the biggest winners under NAFTA, and now take just over half of all U.S. shipments to North America. Their lead reflects their dominance in high-tech manufacturing and, increasingly, motor vehicles, with the latter gains resulting from direct state-sponsored incentives.

Despite the greater freedom of mobility under NAFTA, proximity to the U.S. border is still important. Just over 50% of U.S. exports to Canada originate from the 16 states that border Canada or the Great Lakes. The share of trade along the Mexico-U.S. border is even greater at around 65%. Trade between Texas and Mexico is 20 times larger than trade between Canada and Mexico.

Looking to an FTAA, Mexico has the advantage of bordering some of the fastest growing U.S. states and would gain a southern border with the rest of Latin America. Canada will need to target specific nations more aggressively, as Alberta has done, if not to lose market share. The NAFTA experience also suggest we will see more regional industrial clusters forming along various border lines. I would expect strong competitive pressures within nations as well as between nations.

On net, the impact of NAFTA has been large, and on average positive, but the costs and benefits asymmetric. The same is likely to be true of moving to an FTAA. Combined with the numerous existing bilateral and regional agreements, I believe NAFTA gives good leverage to the FTAA discussions, and some idea of what to expect down the road. In that sense, it is a model, not a perfect model but a good template to move forward with and improve upon.